



Tax Flash News



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Guarantee charges received by a foreign company from its Indian subsidiary are not interest in nature; taxable as 'other income'

Executive summary



The taxability of the guarantee charges received by a foreign company from its Indian subsidiaries has been a debatable issue. Such charges are received by the foreign company for providing the guarantee to the foreign banks in relation to a loan facility to be extended to its Indian subsidiaries by the bank.

The Delhi High Court in the case of *Johnson Matthey Public Limited Company*¹ upheld the decision of the Delhi bench of the Tribunal² on this issue.

The High Court held that the guarantee charges are not in the nature of 'interest' as the foreign company receiving the charges is not a party to the loan agreement. The High Court also held that the charges arose in India as the obligation to pay the charges was incurred in India and it was in respect of services utilised in India.

The High Court did not deal with the question as to whether the guarantee charges could be regarded as business income for the purposes of the tax treaty.

¹ *Johnson Matthey Public Limited Company v. CIT* (ITA No. 717/2018) - Source: Taxsutra

² *Johnson Matthey Public Limited Company v. DCIT* [2018] 191 TTJ 1 (Del)

Facts of the case



The taxpayer, a resident of the UK, entered into a parental guarantee agreement with its subsidiaries (including the Indian subsidiaries).

In accordance with the agreement, the taxpayer provided a guarantee to the foreign banks for extending credit/loan facility to the Indian subsidiaries of the taxpayer.

Pursuant to that guarantee, the banks extended credit facilities to the Indian subsidiaries.

The taxpayer received the guarantee charges from the Indian subsidiaries.

The taxpayer claimed that the charges were in the nature of interest under the India-UK tax treaty³ (the treaty), taxable at the treaty rate of 15 per cent.

The Revenue argued that the charges did not fall within the definition of interest and are taxable as 'other income'⁴ under the treaty which grants taxation rights to India @ 40 per cent⁵ for income arising in India.

³ Article 12(5) of the treaty

⁴ Article 23 of the treaty

⁵ Plus applicable surcharge and cess

Relying on the decision of the Mumbai bench of the Tribunal in the case of *Capgemini*⁶, the taxpayer claimed that the guarantee charges did not accrue or arise in India as the source of income was outside India. The charges were earned for bearing the risk of default on the part of the Indian subsidiaries and the risk was born outside India.

Tribunal's decision



Interest

The treaty defines the interest to mean income from 'debt-claims of every kind'. Under the Act⁷, interest is defined to mean the amount payable in respect of any money borrowed or debts incurred and includes any service fees or other charges in respect of the money borrowed or debt incurred.

The Tribunal held that the definition of 'interest' under the provisions of the Act and the treaty should be interpreted in the context of the usage and with reference to other words and phrases used in the definition. Although the definition includes the words 'claims of every kind' or 'service fee or other charges',

⁶ *Capgemini SA v. DCIT* [2016] 160 ITD 13 (Mum)

⁷ Section 2(28A)

any payment to be qualified as 'interest' have to be in the context of loan and relates to the parties to loan contract even if there is no semblance of creditor-debtor relationship between the parties.

A payment made to the taxpayer who is not a party to the loan contract cannot be treated as an interest payment even though the payments are incidental to the loan.

Accordingly, the guarantee charges were not in the nature of interest.

Business profit

The taxpayer was not in the business of providing corporate/bank guarantees to earn income on a regular basis. The guarantee agreement entered into by the taxpayer is only for the limited purpose of securing loans to its subsidiaries and thus, the guarantee charges cannot be regarded as business profit.

Other income

In the absence of any specific provision dealing with the guarantee charges, it was taxable under 'other income' article which provides that income arising in India may be taxed in India as per the provisions of the Act.

Arising in India

It is not the entering of the guarantee agreement outside India that occasions the taxpayer to receive the guarantee charges, but it is the act of the subsidiary in availing the loan that accrues the charges to the taxpayer. So long as the loan transaction took place in India, the income arose in India.

High Court's decision



The High Court dealt with only two issues (a) whether the guarantee charges are interest in nature (b) whether the charges accrued or arose in India.

The High Court did not deal with the question as to whether the income could be regarded as business income for the purposes of the treaty⁸.

Interest

The charges received by the taxpayer were not in respect of any debt owed to it by the subsidiary. The guarantee agreement did not envisage any claims that the taxpayer could have laid against the subsidiaries in the eventuality that the subsidiaries were to default.

The taxpayer was not a party to the loan agreements between the subsidiary and the banks.

The charges were received as remuneration for providing the guarantee and were not interest in nature.

⁸ Article 7 of the treaty

Place of accrual of income

The accrual of income does not depend upon the actual receipt but would be governed by the principle of a 'right to receive'. The moment a right to receive came into existence, income would be deemed to have arisen or accrued⁹.

The charges were payable irrespective of a default on the part of the Indian subsidiary to discharge its obligation to the banks.

The source of the charges was the agreement to provide guarantee and indemnification. There was a right to receive the income based on the agreement. If the Indian subsidiary were to fail to pay the guarantee charges, the taxpayer has the right to discontinue the service of extending the guarantee.

The obligation to pay charges was incurred in India and it was in respect of services utilised in India. Thus, the charges accrued or arose in India.

The decision of the Mumbai Tribunal in the *Capgemini* was distinguished on the ground that in the instant case, the guarantee charges were not founded on the agreement between the taxpayer and the foreign bank, but sourced and tied to the agreement with the subsidiary.

⁹ *E.D. Sassoon & Company Ltd. v. CIT* [1954] 26 ITR 27 (SC), *Seth Pushalal Mansinghka (P) Ltd. v. CIT* [1967] 66 ITR 159 (SC)

Our comments



The High Court observed that the issue of whether the guarantee charges would constitute business income for the purposes of the treaty is kept open to be addressed in an appropriate case.

It may be noted that if the charges were to be concluded as business income, it would not be chargeable to tax in the absence of a permanent establishment in India. In such a situation, the 'other income' article may not be applicable and the issue whether the income arose in India may not be relevant.

It would be interesting to see how other High Courts and the Supreme Court will deal with the above issues, especially whether the guarantee charges accrue or arise in India.



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